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STATE FOR WHA/MEX, WHA/EPSC, EB/ESC
USDOC FOR 4320/ITA/MAC/WH/ONAFITA/ARUDMAN
USDOC FOR ITS/TD/ENERGY DIVISION
TREASURY FOR IA (ALICE FAIBISHENKO)
DOE FOR INTERNATIONAL AFFAIRS KDEUTSCH AND SLADISLAW
STATE PASS TO USTR (EISSENSTAT/MELLE)
STATE PASS TO FEDERAL RESERVE (CARLOS ARTETA)
NSC FOR DAN FISK, CYNTHIA PENDLETON

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SUBJECT: ECONOMIC TRANSITION NOTES, NOVEMBER 1-8, 2006

REF: A. MEXICO 6313

- [1](#)B. MEXICO 6362
- [1](#)C. MEXICO 5810
- [1](#)D. MEXICO 5343
- [1](#)E. MEXICO 6217

Summary

[1](#)1. (U) Mexico's markets were unaffected by the November 6 bombings. Market expectations are close to government economic predictions, including that the recent inflation spike is temporary and that the government will have its first budget surplus since 1996. The stock market boasted a record gain on November 1, but analysts are waiting to see whether it can remain at this high-level. The government expects to deliver its 2007 budget by December 1, while states are concerned over announced plans to cut their share of federal revenue. The Fox Administration has taken additional steps to improve competitiveness by further cutting tariffs and preparing to issue a new decree for the maquiladora sector. President-elect Felipe Calderon and others continued public calls for reform including in the fiscal system, pensions, infrastructure, energy, and increasing competition in the finance and telecommunications sectors. The telecommunications regulator came under public criticism for its recent changes in cell phone charges and convergence. Declining oil production forced PEMEX to cut supplies to the United States. Meanwhile, PEMEX has launched a public tender for natural gas exploration. Speculation continues about who will be on Calderon's economic team. END SUMMARY.

Markets Not Affected by Bombings

[1](#)2. (U) Markets were not notably affected by the explosion of three bombs in Mexico City shortly after midnight on November 6 (Ref A). The peso lost ground in early trading on November 6, but regained most of its losses during the day. During

the week ending November 7, the peso depreciated by 0.88% and the benchmark stock index gained 2.3%.

Quarterly Report on Inflation

13. (U) On October 31, the Bank of Mexico (BOM) published its report on inflation for the third quarter of 2006. The report highlighted the positive performance of domestic consumption and investment as well as manufacturing and crude oil exports. Inflation -- which was 4.09% during the 12-month period ending in September -- has risen in recent months due to shortages of sugar, unfavorable climate conditions that affected tomato harvests, and higher tortilla prices. The BOM said that the price spike is temporary and forecast that inflation will be around 4.0% at yearend. During this quarter, long-term interest rates fell and the yield curve flattened as domestic political uncertainty lessened and premium risk rates in international markets declined.

Mexico To Post First Budget Surplus since 1996

14. (U) The Finance Secretariat has announced that President Fox plans to hand over an economy growing at its fastest pace in six years, with the first budget surplus since 1996, after record oil prices boosted revenue. The government's surplus is forecast to be 0.2% to 0.3% of GDP because of additional revenue from oil exports and greater-than-expected tax collection. (Note: this measure of the budget balance excludes significant off-budget borrowing. End Note.)

Quarterly Report on Public Finances

15. (U) According to the Finance Ministry's quarterly report on public finance, the Finance Ministry expects the economy

MEXICO 00006424 002 OF 005

to grow 4.3% during the third quarter. The report also says that 835,592 jobs were created in the formal sector during the first nine months of the year. Direct banking credit to the private sector rose at a real rate of 30% in August. Housing credit grew 82.3%, consumer credit rose 45.4%, and lending to businesses increased 11.4% in real terms. The budget surplus during January to September was 32.4% higher in real terms than in the same period in 2005. Government revenues increased 14% due to higher tax collection and revenues from petroleum. Oil-related revenues accounted for 36.6% of total revenues during the first nine months of the year. Total net public debt (the BRHBPS) was 35.5% of GDP, with internal debt representing 24.5% of GDP and external debt representing 11.0% of GDP.

Market Expectations Fairly Close to These GOM Forecasts

16. (U) According to a market expectations survey conducted by the BOM in October, real GDP growth will be 4.54% in 2006 and 3.57% in 2007, while consumer price inflation will be 3.97% in 2006 and 3.47% in 2007. At year end, the 28-day CETES are expected to be 7.1%, and the exchange rate 10.99 pesos to the dollar. The survey also showed that analysts expect a budget surplus of 0.4% of GDP. Foreign direct investment is expected to fall to USD 16.13 billion in 2006 and USD 15.89 billion in 2007.

Bolsa Breaks 23,000 Mark, Continues To Set New Records

17. (U) On November 1, the Bolsa index rose 676.86, or 3%, to 23,046.95, the biggest gain since July 19. Traders predicted that the market will now be looking to test whether the index can stay above 23,000. The Bolsa had fallen 4.4% from an Oct. 25 record on reports the U.S. economy grew less than forecast in the third quarter. The rally had the characteristics of a "technical rebound," in which investors buy after shares fall below levels determined by mathematical models of price movements. The market also reacted to Calderon's public comment that the Mexican Stock Market will have an important role in the country's growth through long-term financing for infrastructure projects, including

the energy sector. Calderon had also promised to maintain the economic stability and the growth of financial markets.

Fitch Releases Post-Electoral Update on Mexico

¶8. (U) On November 7, Fitch Ratings published a special report on Mexico that details some of the challenges confronting President-elect Calderon. The report says that Calderon will have to unite the country behind him, secure governability by marginalizing the civil resistance movement led by former presidential candidate Andres Manuel Lopez Obrador, and build alliances on economic reforms. Fitch is moderately optimistic that Calderon will be able to mobilize Congress in his favor, as his party did well in the election and the PRI performed poorly -- giving him flexibility to strike deals with other political parties. Fitch says that Calderon's main economic challenges include: maintaining the economic recovery; dealing with the prospect of falling crude oil prices and possibly falling oil production during the next six months; and addressing fiscal challenges stemming from the government's dependence on oil revenues.

Unease Over Cuts in Federal Transfers to States

¶9. (U) On October 27, the Finance Secretariat announced it would cut funding to the program that allocates federal funds to state governments by 21%, the Program of Support for the Strengthening of Federal Entities (PAFEF). The Finance Secretariat also decided that PAFEF funds are to only be used

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for infrastructure projects, debt relief, pensions, modernization of the tax system, and expansion of the taxpayer base. This decision caused uneasiness among several governors and PRI deputies. Legislators allege that the total cut to states will be almost USD 2.5 million. The Finance Ministry justified the measure by saying it will create a reserve for the Mexican Social Security Institute (IMSS), but governors say that the decision was made to give

MEXICO 00006424 003 OF 005

priority to programs from the Executive at the expense of those promoted by Congress. (Comment: Mexico's constitution leaves states with minimal sources of revenue other than their federal allocation. End Comment.)

2007 Budget Will be Delivered on Time

¶10. (U) The Fox administration is working closely with the transition team to deliver the 2007 Budget to Congress on time. Guillermo Bernal, Chief of the Budgetary Policies Unit, told the press that it was very possible the budget will be ready to be sent to Congress by December 1. The budget is expected to be similar to last year's. Economic transition team leader Agustin Carstens met in private with legislators of all political parties (including PRD) about the 2007 budget. Carstens warned about the expected fall in revenues due to lower energy prices, and noted pension problems, and the need for strengthening public finances to depend less on crude oil revenues. According to the legislators, Carstens' priority for next year's budget will be to combat poverty.

Maquila Decree Aims to Increase Mexican Competitiveness

¶11. (U) The new Maquila Decree, to be effective November 13, aims to encourage investment and increase Mexico's competitiveness in the global economy. Among other changes, the decree simplifies administrative procedures and lays the groundwork for the export of services under the Maquila program (See Ref B).

More Tariff Reductions

¶12. (U) Under Secretary of Industry and Commerce Rocio Ruiz announced that the Secretariat for the Economy had negotiated with the textile industry to reduce 48 tariffs on textiles, both for artificial and natural fibers. This reduction will include inputs that are still produced in Mexico. On

average, tariffs will be reduced from 9% to zero. These reductions were in addition to broader tariff cuts enacted in September 2006 (Ref E).

Calderon Promises to be an Ally for Competitiveness

¶13. (U) During the conference "Investment and Technology" organized by the Mexican Trade Export Council (COMCE), Calderon told businessmen his government will be an ally for the Mexican export and business sectors in the effort to improve competitiveness and increase market share in order to generate more and better paid jobs. Calderon said that companies established in Mexico need to compete with equal fiscal, financial, and energy conditions as in other countries. He acknowledged that financial costs in Mexico were very high, and that businesses in Mexico need more access to financing at competitive prices.

Finance Secretary Calls for Structural Reforms

¶14. (U) This week, Finance Secretary Francisco Gil Diaz publicly warned that a slowdown in the U.S. economy and the decline of crude oil prices will have a negative impact on the Mexican economy. With this in mind, he called for implementation of structural reforms (fiscal, education, labor, energy, pension, and telecommunications) to improve Mexico's international competitiveness. He noted that economic stability is not enough to reduce widespread poverty. Gil Diaz added that the pension system puts significant pressure on public finances.

Improving Pension Funds in the Long Term?

¶15. (U) Adolfo Albo Chief Economist of the BBVA Bancomer's bank announced that the bank is performing a study on the Mexican pensions system to be published in January 2007.

MEXICO 00006424 004 OF 005

In order to resolve the pensions system's current problems, Albo said that there should be a National Pensions System, which includes all of the existing public systems (Pemex, CFE, universities, IMSS, ISSSTE, etc.) BBVA has elaborated five proposals to improve the system, including an increase in obligatory contributions from 6.5 to 9% of the worker's salary.

Proposals To Improve Competitiveness in the Financial Sector

¶16. (U) Experts from the IMF and the World Bank made several recommendations to improve the financial sector's competitiveness. Their proposals include providing more autonomy to the Banking and Securities National Commission, inspecting foreign banks more closely, constantly monitoring operations of development banks and sofoles (non-bank banks), and establishing a plan for mortgage sofoles. They also recommended promoting more competition in yields paid to customers of private pension funds. They said that authorities should more closely monitor risks associated with consumer credit and mortgages.

Mexico's Public Accountants Urge Fiscal Reform

¶17. (U) During the Mexican Public Accountant Institute's annual convention, Jorge Chavez Presa, a former economic advisor to Roberto Madrazo, said that special regimes, differentiated taxes, high fiscal concentration, pervasive tax evasion, and insufficient incentives for states to collect taxes are the most important challenges to address in a fiscal reform. He said that special regimes generate losses equivalent to 5% of GDP. Another significant problem is that the federal government collects 98.7% of taxes, while the states and municipalities only collect 1.3%. Chavez added that Mexico also needs to simplify the tax system and expand the taxpayer base.

PEMEX Cancelled Shipments to the U.S.

¶18. (U) As reported Ref C, as a result of the declining production from the Cantarell field, Mexican Gulf Coast crude deliveries were short 86,000 B/D during the third quarter of ¶2006. Crude oil production during that period averaged 3.24 million barrels per day, 1% less than during the same period of 2005. For 2007 and 2008, PEMEX estimates are even lower: 1.68 million barrels and 1.43 million barrels daily.

New Contracts to Extract Natural Gas

¶19. (U) According to press reports, PEMEX has launched a public tender to explore and exploit natural gas reserves on a fee-for-service basis. The expected investment is USD 1 billion. Repsol, Petrobras, Techint, Grupo R, and Diavaz will participate in the tender. These companies will present their technical offers in January 2007, and the decision will be made almost immediately. The fields are located in Coahuila, Tamaulipas, and Nuevo Leon. PEMEX publicly claims that natural gas production will increase by 300 million cubic feet daily with this tender.

Calderon Receives Long-Term Infrastructure Plan

¶22. (U) The Mexican Construction Chamber has given Calderon their long-term infrastructure plan. This "Great Vision Project" is the result of a list of proposals derived from five regional forums organized by the Chamber. In receiving the document, Calderon promised his administration will be the "government of infrastructure" because he believes that the investment in infrastructure is the best way to achieve equity and social justice.

Calderon Pledges To Increase Competition in Telecommunications

¶23. (U) On November 2, Calderon publicly pledged to boost competition within the Telmex-dominated telecommunications

MEXICO 00006424 005 OF 005

industry. Calderon said it was "indispensable that Mexico be able to integrate its citizens into a society of information and knowledge." A 2006 OECD report says that telecommunication costs in Mexico are among the highest in the OECD. Telephone coverage is inadequate, with internet and fixed-line phone service still unavailable in many rural areas.

Suspension to "Calling Party Pays" (CPP) System

¶24. (U) Mexican telecommunications companies Alestra, Axtel, Avantel, Marcotel, and Maxcom have filed legal injunctions to suspend long distance CPP. All companies except for Marcotel obtained a temporary suspension from Mexican judges. In addition, Axtel and Marcotel will file a complaint with the Federal Telecommunication's Commission (Cofetel). Marcotel's CEO said that Cofetel is obliging companies to accept the measure rather than creating a positive environment for negotiation. (Note: Despite the injunctions, CPP went into effect in Mexico on November 4. Telmex, which provides 95% of fixed line services in Mexico, implemented CPP, as did mobile phone companies. End Note.)

Injunctions Denied Against Convergence in Telecommunications

¶25. (U) Six cable TV companies filed injunctions against the Convergence Agreement (Ref D) published on October 3, but none of the judges decided to temporarily suspend the agreement, and only one of injunctions was accepted by the judge.

Speculation on Carstens' Finance Team

¶26. (U) According to the press, Carstens asked Alejandro Werner, current Chief of the Economic Planning Unit in the Secretariat for Finance, to become his Under Secretary of

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Expenditures. Jose Antonio Meade from the Rural Finance Division would be Carstens' coordinator of advisors.

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